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June 4, 2001

Mr. Philip A. Leone  
Director  
Joint Legislative Audit and  
Review Commission  
General Assembly Building  
Suite 1100, Capitol Square  
Richmond, Virginia 23219

**via Facsimile and Mail**

**Subject: Return to Work for Retired Teachers**

Dear Mr. Leone:

The 2001 General Assembly amended the *Code of Virginia* to permit teachers to return to work after retirement without reduction of their retirement allowances. There are a number of conditions that would apply to such an individual:

- The retirement allowance will not be changed based upon service or pay after the return to work.
- The individual is hired into a position identified as having a critical shortage of teachers or administrative personnel.
- The individual is not receiving a retirement benefit from an early retirement incentive program from any local school district.
- The person has been receiving such retirement allowance for a "certain period of time" preceding his reemployment.

The "certain period of time" is to be determined jointly by the Board of the Virginia Retirement System (VRS) and the Joint Legislative Audit and Review Commission (JLARC). The legislation specifies that such period will result in "no negative fiscal impact to the Commonwealth."

VRS has proposed that such period of time be set as nine months. Watson Wyatt, actuary to VRS, has provided a letter indicating that a nine-month period (excluding June, July and August) is of sufficient length so as not to impact the assumed rates of retirement and therefore will not result in a material impact to funding.

One of the most difficult tasks for an actuary is to predict behavior related to a change in a retirement plan. This is especially true when there is a lack of similar experience from other retirement systems, as is the case with this change. If the change results in an

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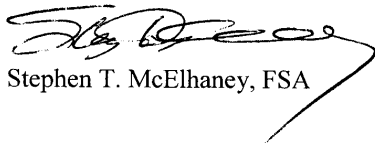
increase in retirement rates at earlier ages, thus decreasing the average retirement age, the employer contribution rate (as a percentage of covered payroll) will be increased. The question then becomes: will the opportunity to return to work without suspension of pension payments cause some individuals to retire sooner than they would have retired in the absence of such a provision?

For a short period of time between retirement and reemployment, the answer to the question posed above would undoubtedly be yes. In fact, Watson Wyatt had derived cost increases for break periods of three and six months, with the higher cost being computed for the shorter period. The longer the period, the less likely it will be that someone will retire earlier just because he can be rehired later. While there may be a few individuals who will retire earlier even with a nine month required break, we do not believe that the number would be material enough to result in a change in the retirement rate assumptions. Therefore, we concur with Watson Wyatt's opinion regarding no material cost related to a nine-month period.

This letter addresses only the VRS cost issues regarding the plan change and does not address other compensation or benefits issues. Issues related to IRS tax qualification of VRS are addressed in a separate letter from Valerie Grace of Mercer.

Please let me know if you have any questions or need any additional information.

Sincerely,



Stephen T. McElhaney, FSA

June 4, 2001

Mr. Philip A. Leone  
Director  
Commonwealth of Virginia  
Joint Legislative Audit and Review Commission  
Suite 1100, General Assembly Building, Capitol Square  
Richmond, VA 23219

Dear Mr. Leone:

We have reviewed the recent amendment to the *Code of Virginia* to permit a retired teacher to return to work without suspension of his or her retirement allowance. In order to qualify for this election, the teacher must have been receiving the retirement allowance for "a certain period of time preceding [re-]employment," with such period to be determined jointly by VRS Board of Trustees and the Joint Legislative Audit and Review Commission "consistent with the federal tax qualification of the plan."

You have asked us to address the following question: What is the shortest break in service for retired teachers prior to re-employment by a school division which would be in full compliance with IRS regulations regarding in-service distributions? In addressing this question, we have considered the proposal from the VRS that the required break in service be 9 months, excluding the months of June, July and August. (Your other question, relating to cost neutrality, is addressed in a separate letter from Steve McElhaney.)

### **Summary**

We are somewhat doubtful that the IRS would approve an across-the-board minimum break in service of any specific duration (e.g., 9 months). Rather, we think the IRS would apply a more subjective analysis, focusing on whether there was a complete and good faith termination of the employment relationship at the time of the teacher's initial retirement.

That said, it's possible that the IRS would allow the VRS to implement a 9-month break rule if it also adopted additional safeguards designed to preclude in-service distributions. These safeguards might include (1) obtaining signed statements at the time of retirement certifying that there is no promise or agreement governing the teacher's later return to service, and (2) allowing the VRS to rely on these certifications except in cases where it has actual knowledge that the teacher's retirement was not in good faith.

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### **Prohibition Against In-Service Distributions**

A pension plan fails to meet the tax-qualification requirements if it allows participants to withdraw the funds accumulated on their behalf prior to “severance of employment” (Rev. Rul. 56-693). However, pension benefits may be paid following a complete and good faith termination of the employment relationship — it makes no difference that the employer subsequently rehires the participant, as long as there was no pre-arranged agreement to do so.

In determining whether an employment relationship has been severed, the IRS (and the courts) will consider all surrounding facts and circumstances. Certainly, the duration of a break in service is one factor that would be taken into consideration — but this factor alone is not determinative. For example, an employee may have a bona fide termination even though he returns just a few weeks later due to changed circumstances. Conversely, an employee would not necessarily be considered terminated merely because he ceases to perform active service for an extended period (e.g., one year leave of absence). And, of course, the IRS would not look favorably on situations where an employee retires in “bad faith” and as a sham in order to circumvent tax rules applicable to qualified plans — only to resume the employment relationship at a later date (see *Barrus v. U.S.* (E.D.N.C. 1969)).

So, in order to determine whether an employee has, in fact, been terminated, we think that the IRS would look at factors other than just the length of the break — perhaps most importantly, whether there was any agreement between the employer and the employee to renew the employment relationship at a later date.

### **Teacher Reemployment Option**

We have considered the proposal from the VRS that the required break in service be 9 months, excluding the summer months. We agree that this 9-month break is more likely than a 3-month summer break to indicate that a genuine termination of employment has occurred. But we do not necessarily agree that a 9-month rule would allow the VRS to automatically accept all retirement applications, without even considering whether there was a complete and good faith termination of the employment relationship at the time of the teacher’s retirement.

Our concern is this: If teachers can return to work without benefit suspension after a 9-month break, this option could become more than just a recruitment tool for retired teachers — it could develop into an impermissible in-service distribution option for teachers who are currently active. It appears that active teachers could,

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in effect, take a sabbatical for one academic year, and then return to the classroom, collecting a full salary along with a full or reduced pension. If this happened on any kind of regular basis, it might not withstand IRS scrutiny.

To avoid this result, you might consider having VRS implement the 9-month break rule (excluding summer) with some additional safeguards intended to minimize the potential for in-service distributions. These safeguards might include, for example:

- Requiring all retiring teachers (and school system representatives) to sign certifications at the time of retirement, confirming that there is no promise, understanding or pre-arrangement regarding the teacher's eventual return to service, such as an implied contract of re-employment (we think that this condition could be waived for teachers who retired before the new law was enacted because these teachers had no expectation that their retirement allowances would continue after return to service); and
- Requiring the VRS to reject retirement applications (and suspend retirement allowances) in any case where it has actual knowledge that the teacher's retirement was not a complete and good faith termination of employment (e.g., where VRS learns that the teacher "retired" pursuant to a pre-arranged plan to return after a one-year break).

With these (or similar) safeguards in place, we do not think it would be necessary for the VRS to go through the burdensome process of independently verifying the circumstances surrounding each teacher's retirement. While we think this is a reasonable approach that is consistent with tax-qualification requirements, we cannot provide assurances that the IRS would agree. Also, before implementing these rules, the Commonwealth and VRS should consider whether they have the authority to do so under state law and any applicable collective bargaining agreements.

As you know, William M. Mercer, Incorporated is not a law firm and cannot render legal advice. We recommend that you discuss this issue with legal counsel.

Sincerely,



Valerie S. Grace

Cc: Stephen McElhaney